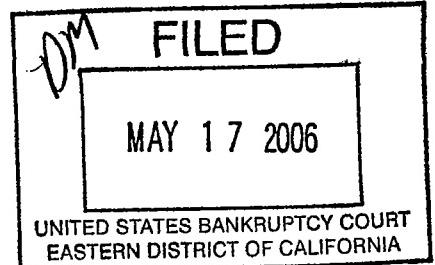


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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA
FRESNO DIVISION

In re } Case No. 04-11065-B-11
Waterman Industries, Inc., } DC No. WLG-145
Debtor. } DC No. MTH-1

**MEMORANDUM DECISION RE OBJECTION TO ADMINISTRATIVE CLAIM
OF CELTIC LEASING AND COUNTER-MOTION FOR PAYMENT OF
ADMINISTRATIVE CLAIM**

Riley C. Walter, Esq., of Walter Law Group, appeared on behalf of the debtor in possession, Waterman Industries, Inc. (the "Debtor").

Michael T. Hertz, Esq., of Lang, Ritchert & Patch, appeared on behalf of respondent to counter-movant Celtic Leasing Corp., ("Celtic").

Donald W. Fitzgerald, Esq., of Felderstein Fitzgerald Willoughby & Pascuzzi, LLP, appeared telephonically on behalf of the Official Committee of Unsecured Creditors (the "Committee").

Randy Rogers, Esq., of Winston & Strawn LLP, appeared on behalf of secured creditor Galena National Investments LLC, ("Galena").

The Debtor objects to an Administrative Expense Proof of Claim filed by Celtic (the “Celtic Claim”). Celtic responded to the objection with a counter-motion to allow and pay the Celtic Claim as an administrative expense. The parties dispute both the administrative priority and the amount of the Celtic Claim. After oral argument, the court took the matter under submission to decide the administrative priority issue, *i.e.*, whether the contracts between Celtic and the Debtor constitute a true lease of personal property, or a non-lease financing agreement disguised as a lease. The outcome of that issue will determine whether Celtic is entitled to have its claim paid, in whole or in part, as an administrative expense pursuant to sections 365(d)(10) and 503(b) of the Bankruptcy Code.¹ Celtic also asserts a claim for alleged conversion of the leased equipment. For

¹Unless otherwise indicated or made clear from the context, all chapter, section and rule references are to the Bankruptcy Code, 11 U.S.C. § 101-1330, and to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as enacted and promulgated prior to the effective date of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, Apr. 20, 2005, 119 Stat. 23.

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1 the reasons set forth below, the court finds and concludes that Celtic is entitled to an
2 administrative claim under § 365(d)(10) for the lease payments that came due before the
3 lease was rejected. Celtic is also entitled to an administrative claim for the post-rejection
4 possession and use of the leased equipment in an amount to be determined pursuant to
5 § 503(b). Liquidation of the § 503(b) claim, and allowance of Celtic's conversion claim,
6 if any, will require a further evidentiary hearing.

7 This Memorandum Decision contains findings of fact and conclusions of law
8 required by Federal Rule of Bankruptcy Procedure 7052 and Federal Rule of Civil
9 Procedure 52. The bankruptcy court has jurisdiction over this matter pursuant to 28
10 U.S.C. § 1334 and 11 U.S.C. §§ 365 and 503. This is a core proceeding pursuant to 28
11 U.S.C. 157(b)(1)(B).

12 **Findings of Fact**

13 Debtor manufactures water control equipment and has been in business since
14 1912. Debtor's products are sold worldwide. They include control gates, valves, and
15 related equipment serving the irrigation and water control needs of the agriculture and
16 wastewater treatment industries. Debtor's manufacturing and business operations are
17 dependant upon computers and computer software.

18 In 1996, Debtor and Celtic entered into an agreement entitled "Master Lease
19 Celtic Leasing Corp. - Lessor" (the "Master Lease"). In November 2001, Debtor signed
20 Schedules 2 and 3 (collectively, the "Schedules"), which added computer hardware and
21 software (the "Equipment") to the Master Lease. Also in November 2001, Celtic filed
22 two UCC-1 Statements in connection with the Equipment, which stated "this filing is for
23 precautionary purposes in connection with a leasing transaction and is not to be construed
24 as indicating that the transaction is other than a true lease." On December 7, 2001, and
25 February 6, 2002, the Debtor entered into agreements to assign lease payments related to
26 Schedules 2 and 3 respectively, to Wells Fargo Equipment Finance, Inc., for the Base
27 Term of the Schedules. Those agreements were both entitled "Assignment of Lease" (the
28 "Wells Fargo Assignments").

1 Debtor filed this chapter 11 case on February 10, 2004. Debtor's Chief
 2 Restructuring Officer, Kenneth Leddon ("Leddon") signed the Debtor's bankruptcy
 3 schedules as an authorized representative. Bankruptcy Schedule G states that the Debtor
 4 was obligated to Celtic under a lease or executory contract in "Computer Equipment."
 5 After the Debtor filed bankruptcy, it continued to use the Equipment. On June 23, 2004,
 6 more than 60 days after the commencement of the case, Debtor exercised its right to
 7 extend the Master Lease and the Schedules for one year from April 1, 2005, through April
 8 1, 2006, (the "2005 Extension"). The Master Lease, the Schedules, and the 2005
 9 Extension are hereinafter collectively referred to as the "Lease" or the "Celtic Lease."

10 The Lease was apparently extended at least twice between the expiration of the
 11 Base Term and the 2005 Extension. In a cover letter to the 2005 Extension, Leddon
 12 confirmed the Debtor's intent to extend the Master Lease and the Schedules for one more
 13 year:

14 As you know, the original term of this agreement has been extended by
 15 amendment to April 1, 2005. Therefore, the additional year term would extend
 16 the agreement to April 1, 2006 at which time the equipment will either be
 purchased by Waterman or returned.

17 The Master Lease defines the nature and scope of the agreement:

18 This is a MASTER LEASE AGREEMENT (herein called "Lease"). Lessor
 hereby agrees to lease to Lessee, and Lessee hereby agrees to lease from Lessor,
 19 the items of personal property (collectively called "Equipment" and individually
 20 called an "Item") described in any Lease Schedule(s) ("Schedule") now or in the
 future annexed hereto and made a part hereof, subject to the terms and conditions
 set forth herein.

21 The Master Lease gives the Debtor the right of possession and quiet enjoyment for
 22 the leased property:

23 1. QUIET ENJOYMENT: So long as Lessee is not in default hereunder, Lessor
 shall not disturb Lessee's quiet enjoyment of the Equipment subject to the terms
 24 and conditions of this Lease.

25 The Master Lease provides for termination at the end of the "Base Term" as
 26 follows:

27 4. TERM: This Lease with respect to any Schedule may be terminated as of the
 last day of the Base Term by either party giving the other party at least six months
 28 but not more than twelve months prior written notice of such termination.

1 The Master Lease further provides that Celtic shall retain title to the leased
2 property, including the software licenses:

3 **7. TITLE; PERSONAL PROPERTY:** Except as otherwise provided in this Lease
4 or any Schedule hereto, title to the Equipment shall at all times remain in Lessor.
5 In the event that any of the Equipment is software governed by a software license,
6 Lessee shall keep said license current for the entire lease term and, to the extent
7 the license allows title to the software to pass to licensee, such title shall vest and
8 remain in Lessor. To the extent that such vesting requires a written conveyance
9 from Lessee, Lessee hereby conveys to Lessor any title it has or may hereafter
acquire in the software and foregoes any future claim to the software including
any right to purchase and/or use the software beyond the lease term except as
otherwise provided in this Lease or the related Schedule. If the software license
restricts any provision of this Lease without the licensor's consent, then Lessee
shall assist Lessor, if so requested, in obtaining such consent.

10 The Master Lease contains a "purchase or renewal" option, which may be
11 exercised at the end of the Base Term:

12 **20. FAIR MARKET VALUE PURCHASE OR RENEWAL OPTION:** Lessee
13 may purchase or renew this Lease for all but not less than all of the Equipment
14 subject to any Schedule as of the expiration of the Base Term or any Extension
Term at its then fair market value, as mutually agreed by Lessee and Lessor
15 In the event Lessee and Lessor cannot agree on a fair market value, then the fair
market value shall be determined by the average appraisal of three appraisers

16 The Schedules both modified the "purchase or renewal" option to fix a time for
17 giving notice of Debtor's election and a fair market value in the event of a purchase. The
18 Schedules each state:

19 Lessee has irrevocably elected to exercise its option to purchase or renew the
20 above referenced Lease with respect to the above referenced Schedule as of the
expiration of the Base Term of said Schedule at its then fair market value
("FMV"). At least six months prior to the expiration of the Base Term, Lessee
21 shall provide Lessor with written notice of its decision to: (a) purchase the subject
Equipment; or (b) renew the Schedule. Lessee and Lessor hereby mutually agree
22 that: (i) if Lessee chooses (a), above, then the FMV purchase price shall be 36.8%
of the total Equipment cost, which cost includes all related disbursements made
by Lessor or its Assignee; and (ii) if Lessee chooses (b), above, then the FMV
23 renewal of the Schedule shall consist of a one year extension at the rental amount
in effect as of the last billing cycle of the Base Term. . . .

24 The 2005 Extension confirms and restates the efficacy of the Master Lease:

25 **8.1** Except as revised or amended or modified herein, all other terms and
conditions of the Lease and all other documents attached thereto or incorporated
therein remain fully enforceable and in effect and are incorporated herein and
shall remain fully enforceable and in effect and survive any default herein by the
Customer.

26 ///

1 A recital in the 2005 Extension confirms Celtic's title to the Equipment: "The
 2 property that is the subject of the Lease is owned by Celtic."²

3 The Debtor made the Lease payments to Celtic until April 2005, when the
 4 payments stopped. On June 16, 2005, Debtor moved to reject the Lease with a pleading
 5 entitled "Motion for Authority to Reject Unexpired Leases (Celtic Leasing Corp.)" (the
 6 "Rejection Motion"). In the Rejection Motion, the Debtor repeatedly referred to the
 7 subject agreement as a "lease." The Rejection Motion states the "Debtor is a party to
 8 several unexpired leases, many of which relate to leased equipment, no longer needed in
 9 Debtor's downsized operation." It ended by noting that "[t]he Debtor believes that the
 10 subject unexpired leases should be rejected because they are costly to maintain and
 11 continually upgrade, and are unnecessary given Debtor's current circumstances." The
 12 Debtor prayed for the following relief:

13 court order authorizing it to reject the subject unexpired leases and, if granted, that
 14 the claims resulting from the rejection be filed within sixty (60) days of service of
 15 a copy of the order granting this Motion upon each claimant whose
 16 lease is rejected, and seeks such other and further relief as is just and proper.

17 Leddon signed a declaration in support of the Rejection Motion. He declared that
 18 he was "familiar with the unexpired leases" and that "[t]here are three (3) equipment
 19 lease contracts sought to be rejected by [the Rejection Motion]." He further stated, "[i]n
 20 my business judgment, I assert that these leases are not economically feasible, confer no
 21 benefit on the estate and should be rejected." He based this on "over 15 years experience
 22 in the financial management of distressed companies" and status as a "Certified
 23 Insolvency and Restructuring Advisor (CIRA) and Certified Turnaround Professional

24 ²Notably, the 2005 Extension also contained the following language regarding
 25 the advice of its counsel:

26 9. ADVICE OF COUNSEL. The Customer [Waterman] acknowledges that it
 27 has reviewed this Amendment in its entirety, having consulted such legal, tax or
 28 other advisors as it deems appropriate and understands and agrees to each of the
 provisions of this Amendment and further acknowledges that it that it has
 entered into this Amendment voluntarily.

1 (CTP)."

2 The Rejection Motion was granted. Celtic submitted the form of order entitled
 3 "Order Re Motion For Authority to Reject Unexpired Leases (Celtic Leasing Corp.),"
 4 which was entered on July 8, 2005. That order specifically authorized the Debtor "to
 5 reject the entire lease contracts [the Master Lease, Schedules, and Wells Fargo
 6 Assignments]" and set a bar date for the filing of "[a]ny claim(s) resulting from the
 7 rejection of the unexpired leases shall be filed within sixty (60) days of service of this
 8 Order."

9 On August 5, 2005 Celtic made a demand upon the Debtor for return of the
 10 Equipment under the rejected Lease.³ Celtic also made a demand for the post-petition
 11 payments due under the Lease, which were still in default. Celtic timely filed the Celtic
 12 Claim on August 17, 2005. On August 23, 2005, Debtor filed an objection to the Celtic
 13 Claim, but withdrew it two days later.

14 In November 2005, Debtor filed the contested matter now before the court entitled
 15 "Objection to Administrative Expense Proof of Claim Number 335 (Celtic Leasing
 16 Corporation)" (the "Claim Objection"). Celtic filed a counter-motion for payment of the
 17 Celtic Claim as an administrative expense of the estate.

18 **Issue Presented**

19 The issue of whether Celtic is entitled to an administrative claim turns on whether
 20 the agreement between the parties constitutes a true lease or whether it amounts to a non-
 21 lease agreement, such as a financing or security agreement, disguised as a lease. If the
 22 agreement was a true lease, then Celtic has an administrative claim under 11 U.S.C. §§
 23 365(d)(10) and 503(b) based on the Debtor's pre-rejection obligation under the Lease and
 24

25 ³At the time of the oral argument in this matter, five months after entry of the
 26 order granting the Rejection Motion, none of the Equipment had been returned to Celtic.
 27 There appears to be a material dispute between the parties whether the Debtor refused to
 28 tender the Equipment or Celtic refused to accept it. Celtic contends that the software
 has not been removed from the Debtor's computers and is still being used. That issue
 will be addressed in a subsequent proceeding when the court determines the amount of
 Celtic's § 503(b) administrative claim.

1 post-rejection possession and use of the Equipment. If the agreement is a financing and
 2 security agreement, Celtic has an unsecured claim for a deficiency after liquidation of its
 3 collateral.

4 **Analysis and Conclusions of Law**

5 **Applicable Law**

6 The Debtor's obligation to perform an unexpired personal property lease under §
 7 365(d)(10)⁴ gives rise to an administrative claim regardless of whether the lease is
 8 subsequently rejected, and regardless of whether use of the leased property benefitted the
 9 estate. *See In re Pacific-Atlantic Trading Co.*, 27 F.3d 401, 403-05 (9th Cir. 1994)
 10 (construing identical "trustee shall timely perform" language in § 365(d)(3) regarding an
 11 unexpired lease of non-residential real property). *See also In re Rebel Rents, Inc.*, 291
 12 B.R. 520, 533 (Bankr. C.D. Cal. 2003) (applying the analysis in *Pacific-Atlantic Trading*
 13 *Co.* to a personal property lease under § 365(d)(10)).

14 Celtic has the burden of proving that it has an administrative claim based, *inter*
 15 *alia*, on the Lease. *In re DAK Industries, Inc.*, 66 F.3d 1091, 1094 (9th Cir. 1995).
 16 However, the burden is on Debtor to demonstrate by a preponderance of the evidence that
 17 the Master Lease, the Schedules, and the 2005 Extension are not what they purport to be,
 18 a true lease. *See In re Murray*, 191 B.R. 309, 316 (Bankr. E.D. Pa. 1996).

19 The issue of whether an agreement is a lease or a non-lease security agreement is
 20 governed by state law. *In re Rebel Rents*, 291 B.R. at 525. Here, the Master Lease
 21 contains the following choice of laws provision: "APPLICABLE LAW: This Lease shall
 22 be construed in accordance with and shall be governed by the laws of the State of

23
 24 ⁴11 U.S.C. § 365(d)(10) sets forth the Debtor's duties under an unexpired
 25 personal property lease:

26 (10) *The trustee shall timely perform all of the obligations of the debtor . . . first*
 27 *arising from or after 60 days after the order for relief in a case under chapter 11 of this*
title under an unexpired lease of personal property . . . until such lease is assumed or
rejected notwithstanding section 503(b)(1) of this title, unless the court, after notice and
a hearing and based on the equities of the case, orders otherwise with respect to the
 28 *obligations or timely performance thereof. . . . (emphasis added.)*

1 California.” Therefore, the court will apply California law to determine the true nature of
 2 the agreement. Because the applicable California statute, which defines the difference
 3 between a security interest and a lease, Cal. Comm. Code § 1201(36) is based on Uniform
 4 Commercial Code § 1-201(37), the court may also look to decisions from other
 5 jurisdictions which interpret the U.C.C. *See In re Rebel Rents*, 291 B.R. at 526.

6 **California Commercial Code**

7 Cal., Comm. Code § 10103(a) defines a personal property lease as:

8 (10) “Lease” means a transfer of the right to possession and use of goods for a
 9 term in return for consideration, but a sale, including a sale on approval or a sale
 10 or return, or retention or creation of a security interest is not a lease. Unless the
 context clearly indicates otherwise, the term includes a sublease.

11 Cal. Comm. Code § 1201(36)(b) delineates the distinction between a lease and a
 12 security interest, in pertinent part, as follows:

13 (b) Whether a transaction creates a lease or security interest is determined by the
 14 facts of each case. However, a transaction creates a security interest if the
 15 consideration the lessee is to pay the lessor for the right to possession and use of
 the goods is an obligation for the term of the lease not subject to termination by
 the lessee, and any of the following conditions applies:

- 16 (i) The original term of the lease is equal to or greater than the remaining
 economic life of the goods.
- 17 (ii) The lessee is bound to renew the lease for the remaining economic life
 of the goods or is bound to become the owner of the goods.
- 18 (iii) The lessee has an option to renew the lease for the remaining
 economic life of the goods for no additional consideration or nominal
 additional consideration upon compliance with the lease agreement.
- 19 (iv) The lessee has an option to become the owner of the goods for no
 additional consideration or nominal additional consideration upon
 compliance with the lease agreement.

20 (c) A transaction does not create a security interest merely because it provides one
 21 or more of the following:

- 22 (i) That the present value of the consideration the lessee is obligated to pay
 the lessor for the right to possession and use of the goods is substantially
 equal to or greater than the fair market value of the goods at the time the
 lease is entered into.
- 23 (ii) That the lessee assumes the risk of loss of the goods, or agrees to pay
 the taxes, insurance, filing, recording, or registration fees, or service or
 maintenance costs with respect to the goods.

(iii) That the lessee has an option to renew the lease or to become the owner of the goods.

(iv) That the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed.

(v) That the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

To show that Celtic's Lease is actually a security agreement, the Debtor must establish that it has no right to voluntarily terminate the Lease and that one of the four provisions identified in section 1201(36)(b)(i) through (iv) applies. This inquiry has been referred to as the "Bright-Line Test." *In re Lerch*, 147 B.R. 455 (Bankr. C.D. Ill. 1992).

The Terminability Factor

The first prong of the Bright-Line Test focuses on whether the agreement is subject to termination by the lessee, *i.e.*, whether the lessee is obligated to pay the entire amount for the lease term without the right to terminate the lease early. If the consideration the lessee must pay for the term of the lease is not subject to termination by the lessee, then the transaction meets the first prong. *In re QDS Components, Inc.*, 292 B.R. 313, 332 (Bankr. S.D. Ohio 2002). Here, paragraph 4 of the Master Lease authorizes termination by the Debtor, but only at the end of the Base Term of the Master Lease. The Schedules establish a new Base Term for the Schedules themselves, but they did not modify the Master Lease to authorize an early termination. The 2005 Extension extended the term of the Lease for an additional year without a right of early termination. It appears that the Debtor's obligation to pay Celtic was not subject to early termination. The court must therefore look at the Lease to see if any of the other factors under Cal. Comm. Code § 1201(36)(b) apply.

Residual Value Factors

Subsections (i) through (iv) of § 1201(36)(b) are referred to as the Residual Value Factors. *In re QDS Components, Inc.*, 292 B.R. 313, 332 (Bankr. S.D. Ohio 2002). If the lease is not subject to early termination, and one of these Residual Value Factors is

1 present, then the court's inquiry ends and the transaction is deemed to have created a
2 security interest. *Id.* at 333.

3 With regard to subsection 1201(36)(b)(i), the original term of both Schedules 2
4 and 3 appears to be less than the remaining economic life of the Equipment. Both
5 Schedules state an original "Base Term" of 24 months, which would have expired in
6 November 2003. At the end of the Base Term, the Equipment had remaining economic
7 life as evidenced by the fact that the Debtor elected to extend the Lease and continued to
8 use the Equipment after the Base Term expired. The Debtor failed to establish that the
9 Base Term of the Lease is equal to or greater than the remaining economic life of the
10 Equipment. Therefore, the "economic life" factor embodied in Cal. Comm. Code
11 § 1201(36)(b)(i) is not present.

12 With regard to subsection 1201(36)(b)(ii), that factor is met when the lessee is
13 "bound," meaning contractually obligated, to renew the Lease "for the remaining
14 economic life of the goods," or is bound to become the owner of the goods. Stated
15 differently, the Lease must require the Debtor to either renew the Lease for the remaining
16 economic life of the Equipment, or to purchase the Equipment for the fair market value
17 agreed to in the Schedules, 36.8% of its original cost. The specific language in the Lease
18 is recited above.

19 The Debtor was not contractually obligated to renew the Lease for the remaining
20 economic life of the Equipment, or for any other term. The Debtor had an *option* to
21 purchase the Equipment or to renew the Lease for one year. There is no evidence to
22 suggest that a one-year extension amounts to "the remaining economic life of the goods."
23 Similarly, the Debtor was not contractually obligated to become the owner of the
24 Equipment; again, that was an available option. Indeed, Leddon's Cover Letter to the
25 2005 Extension kept open the option to surrender the Equipment all together. It states
26 that at the end of the 2005 Extension, Debtor will "buyout the equipment . . . at fair
27 market value, or return it to the Lessor." Accordingly, the "bound to renew or become the
28 owner" factor embodied in § 1201(36)(b)(ii) is not present.

With regard to subsections 1201(36)(b)(iii) and (iv), the issue is whether the “renew or own” options were valued at “nominal or no additional consideration.” Under the Master Lease, the “renewal option” was based upon the then “fair market value of the Equipment” and “subject to the then prevailing interest rates, Lessee’s credit standing, and such other terms and conditions to be mutually agreed upon by Lessee and Lessor.” Under the Schedules, the “renewal option” was tied to “the rental amount in effect as of the last billing cycle of the Base Term.” Under the 2005 Extension, the Debtor did not reserve the option to renew at all. Turning now to the “purchase option,” under the Master Lease, the “purchase option” was fixed at the Equipment’s “fair market value” at the expiration of the lease term. The Schedules both fix the purchase price at 36.8% of the Equipment’s total cost. Again, at no time were the “renew or own” options available to the Debtor for “no additional consideration.”

Therefore, the remaining issue is whether the “renew or own” options were available to the Debtor for “nominal” consideration. Subsection 1201(36)(d)(i) of the Cal. Comm. Code defines when consideration is and is not “nominal” within the meaning of subsection 1201(36)(b):

Additional consideration is not nominal if (A) when the option to renew the lease is granted to the lessee, the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed, or (B) when the option to become the owner of the goods is granted to the lessee, the price is stated to be the fair market value of the goods determined at the time the option is to be performed. Additional consideration is nominal if it is less than the lessee’s reasonably predictable cost of performing under the lease agreement if the option is not exercised.

Here, under the Master Lease, the Debtor had the option to renew the lease at the end of the Base Term, or any extended term, for “its then fair market value” to be determined by agreement of the parties or by independent appraisers. This is in line with what Cal. Comm. Code § 1201(36)(d)(i) defines as “*not nominal*” consideration. Under the Schedules, the consideration required to renew was “the rental amount in effect as of the last billing cycle of the Base Term.” Again, this is not “nominal.” The fact that the “renewal” rental was fixed in the Schedules as the prior rental amount suggests that the

1 renewal option was for at least fair market value. The Debtor offered no evidence that the
 2 consideration required to renew was “nominal.” Therefore, § 1201(36)(iii) is not met.

3 As for the “purchase option,” under the Master Lease and the 2005 Extension, the
 4 Debtor was required to pay “fair market value” in order to purchase the Equipment. This
 5 is not “nominal consideration.” Under the Schedules, the consideration for the purchase
 6 option was fixed at “36.8% of the total Equipment cost, which cost includes all related
 7 disbursements made by Lessor or its Assignee.” Again, this “fixed” price is not nominal
 8 under § 1201(36)(d)(i).

9 In 1990, the Cal. Comm. Code § 1201 was amended to conform to revisions made
 10 by the drafters of the Uniform Commercial Code to § 1-201. *In re QDS Components,*
 11 *Inc.*, 292 B.R. 313, 330 (Bankr. S.D. Ohio 2002) (applying California law). The 1990
 12 amendment eliminated any reference to a percentage test for nominality. *See In re*
 13 *Charles*, 278 B.R. 216, 224 (Bankr. D. Kan. 2002) (holding that the enactment of new
 14 U.C.C. § 1-201(37), which disavows percentage tests, supersedes the authorities applying
 15 the percentage tests (quoting White & Summers, U.C.C. § 30-3, 4 ed. 1995 &
 16 Supp.2001)); *In re Beckham*, 275 B.R. 598, 604 (D. Kan. 2002) (concluding that Tenth
 17 Circuit authority endorsing a bright-line rule that option prices of less than 25% of the
 18 original equipment cost are per se nominal “has been superceded by the amendments to
 19 [§ 1-201(37)]”).

20 Moreover, even if the percentage test had survived the enactment of U.C.C. §
 21 1-201(37), courts and commentators have pointed out that such tests are not a reliable
 22 indicator of nominality. *See In re APB Online, Inc.*, 259 B.R. 812, 819-20 (Bankr.
 23 S.D.N.Y. 2001) (rejecting percentage tests because they are “the crudest proxies for the
 24 correct calculation”(quoting 4 White & Summers, U.C.C. § 30-3 at 20)).

25 In this case, the court is persuaded that 36.8% of the Equipment cost is “not
 26 nominal.” The Debtor presented no evidence on this point. Therefore, § 1201(36)(iv) is
 27 not met. As a result, the Bright Line Test has not been satisfied. The Celtic Lease
 28 appears from its terms to be a true lease.

1 The Economic Realities of the Transaction

2 Finally, after determining that the “Bright Line Test” has not been satisfied, the
 3 court must examine the “economic realities” of the transaction. *In re QDS Components*,
 4 292 B.R. at 333 (citing *In re Triplex Marine Maintenance, Inc.*, 258 B.R. 659, 669
 5 (Bankr. E.D. Tex. 2000)). The key issue in this inquiry is whether the lessor retains a
 6 meaningful residual interest at the end of the lease term. *Id.* If there is a meaningful
 7 reversionary interest for the lessor--either an up-side right or a down-side risk--the parties
 8 have entered into a lease, not a security agreement. If there is no reversionary interest, the
 9 parties have entered into a security agreement. *In re QDS Components*, 292 B.R. at 333
 10 (quoting White & Summers, § 30-3 at 30).

11 Under California law, in determining whether the lessor retained a meaningful
 12 reversionary interest, the court considers two factors: (1) whether the purchase option
 13 price is nominal; and (2) whether the agreement contains any provision for the lessee’s
 14 acquisition of equity in the subject property. *Addison v. Burnett*, 41 Cal. App. 4th 1288,
 15 1296 (1996). The *Addison* court looked to the bankruptcy court’s decision in *In re*
 16 *Zaleha*, 159 B.R. 581, 585 (Bankr. D.C. Idaho 1993) for an explanation of the “economic
 17 realties” test:

18 If a lease contains an option to purchase for no or nominal consideration . . . it
 19 suggests that the lessor does not care, in an economic sense, whether or not the
 20 option is exercised. If the lessee develops equity in the leased property such that
 21 the only sensible decision economically for the lessee is to exercise the option . . .
 22 it suggests the lessor did not expect the return of leased goods.

23 Here, Application of the *Addison* factors leads to a determination that Celtic
 24 retained a meaningful reversionary interest in the Equipment. As elucidated above, the
 25 purchase option price was not “nominal.” Nothing in the Master Lease, the Schedules, or
 26 the 2005 Extension created an equity interest for the Debtor in the Equipment. Indeed,
 27 the Debtor expressly reserved the right to purchase the Equipment or surrender it at the
 28 end of the 2005 Extension, which suggests that the Debtor had no expectation of
 29 acquiring an equity interest, or owning the Equipment, without paying for it at fair market
 30 value. Therefore, the *Addison* factors are absent: Celtic did retain a meaningful residual,

1 or reversionary interest in the Equipment.

2 The Debtor argues that the Master Lease is a finance/security agreement because
 3 the Equipment was obtained from a third-party supplier; stated differently, because Celtic
 4 did not manufacture the Equipment. This fact is not conclusive of the issue because
 5 Celtic retained a “meaningful reversionary interest” in the Equipment. *See, e.g., In re*
 6 *Edison Bros. Stores, Inc.*, 207 B.R. 801, 821 (Bankr. D.Del. 1997). (“[T]he fact that the
 7 role of the lessor is that of a financier is inconclusive to show that a disguised secured
 8 transaction was intended because this kind of three party transaction is typical in true
 9 lease[s] as well as in installment sales.”).

10 Galena argues that it has a security interest in the Equipment that is senior to that
 11 of Celtic. It points to the fact that Galena has a financing statement which was filed
 12 earlier in time than Celtic’s financing statement. However, Galena’s argument begs the
 13 question of whether the Master Lease constituted a true lease. The filing of a financing
 14 statement by a lessor is not determinative of true lease status. *See, e.g., In re Owen*, 221
 15 B.R. 56, 62 (Bankr. N.D.N.Y. 1998). (“The fact that [the lessor] filed financing
 16 statements . . . [does not establish a disguised security agreement]. Rather, . . . the filing
 17 of the financing statement was the result of an abundance of caution to assure that [the
 18 lessor’s] rights were protected.”)

19 Debtor contends that Celtic simply financed the Debtor’s purchase of the
 20 Equipment. Debtor argues that Celtic never owned the Equipment and was not the
 21 licensee of the software. However, a financing agreement can be in the form of a true
 22 lease, the two concepts are not mutually exclusive. Under Cal. Comm. Code § 10103(7),
 23 a “finance lease” is a true lease if certain elements are met; namely, (1) the lessor does not
 24 manufacture or supply the goods, (2) the lessor acquires the goods or the right to
 25 possession and use of the goods in connection with the lease, and (3) the right to
 26 possession and use of the goods is a condition to the effectiveness of the lease contract.
 27 All of these elements exist with regard to the Lease. Celtic did not manufacture or supply
 28 the Equipment. The Debtor had the right to “quiet enjoyment” possession and use of the

1 Equipment only during the term of the Lease. By the terms of the Lease, Celtic owned
 2 the Equipment at all times, which gave it the right to possession and use of the goods
 3 upon expiration of the Lease if the Debtor did not exercise the purchase option. Add to
 4 this the “economic realities” analysis based on the absence of the two *Addison* factors
 5 above, and the Debtor’s argument fails.

6 The Debtor further argues that Celtic never owned the Equipment. However, the
 7 Debtor’s argument is inconsistent with the express language in the Master Lease and the
 8 2005 Extension, both of which the Debtor signed. The Master Lease states, “Except as
 9 otherwise provided in this Lease or any Schedule hereto, title to the Equipment shall at all
 10 times remain in Lessor.” The 2005 Extension states, “The property that is the subject of
 11 the Lease is owned by Celtic.” In the 2005 Extension, the Debtor also reserved the right
 12 to surrender the Equipment back to Celtic. Based on the plain language in these
 13 documents, the Debtor is not in a position to argue now that Celtic was not the owner of
 14 the Equipment, or that the Debtor ever intended to own the Equipment. The Debtor
 15 offers no evidence that it ever treated the Equipment as its own. For example, there is no
 16 evidence as to how the Debtor treated the Equipment for tax reporting purposes, *i.e.*, did
 17 it deduct the Lease payments as a business expense or depreciate the Equipment
 18 according to an approved depreciation schedule?

19 In Leddon’s declaration, he states that he “believed” that Celtic never owned the
 20 Equipment. Leddon’s declaration is disingenuous and unworthy of any weight. There is
 21 no evidence that Leddon, as the Debtor’s “Chief Restructuring Officer,” was even around
 22 in 1996 and 2001 when the Debtor signed the Master Lease and the Schedules
 23 respectively, so he had no personal knowledge of what the Debtor intended the
 24 documents to mean. Further, Leddon’s self-serving and opportunistic statement starkly
 25 contradicts all of the documents which he actually signed and filed with the court during
 26 the course of this case. Finally, his declaration of “belief” is largely irrelevant under §
 27 1201(36), as the Official Comment to the U.C.C. states:

28 ///

1 Reference to the intent of the parties to create a lease or security interest has led to
 2 unfortunate results. In discovering intent, courts have relied upon factors that were
 3 thought to be more consistent with sales or loans than leases. Most of these
 4 criteria, however, are as applicable to true leases as to security interests. Examples
 5 include the typical net lease provisions, a purported lessor's lack of storage
 facilities or its character as a financing party rather than a dealer in goods.
*Accordingly, amended [U.C.C.] Section 1-201(37) deletes all reference to the
 parties' intent.* (emphasis added.)

6 Cal. Comm. Code § 1201(36) cmt. Uniform Commercial Code.

7 Galena and the Committee both argue that the Lease may be a "sham" transaction.
 8 Galena and the Committee disregard the fact that the Debtor bears the burden of proof on
 9 that allegation. The Debtor certainly did not treat the Lease as a "sham" before its chapter
 10 11 plan got confirmed and before Celtic started pushing for payment of an administrative
 11 claim. The court cannot even consider this argument without admissible evidence. The
 12 Master Lease, the Schedules, and the 2005 Extension are clear and unambiguous, and all
 13 the parties to these agreements were sophisticated. This court will honor the plain
 14 language of the contract in the absence of a reason to do otherwise. *See Sharon Steel*
 15 *Corporation v. Chase Manhattan Bank, N.A.*, 691 F.2d. 1039, 1048 (2nd Cir. 1982).

16 Finally, the court notes that the Debtor has repeatedly referred to the Lease as a
 17 "lease" in all of its pleadings throughout the course of this bankruptcy case. For example,
 18 in the Rejection Motion, the Debtor referred to and treated the Lease as a "lease." In
 19 addition, the Wells Fargo Assignments were replete with references to the term "lease."
 20 The Debtor's sudden and opportunistic change of position now, after the chapter 11 plan
 21 has been confirmed, and the time has come to actually pay the administrative claims, does
 22 not pass the proverbial "smell test."

23 **Calculation of the Administrative Expense Claim**

24 The full amount of Celtic's administrative claim remains unliquidated, but some
 25 of it can be allowed and paid immediately. There are three distinct components to
 26 Celtic's Claim. First, Celtic argues that it is entitled to receive the post-petition lease
 27 payments that came due during the pre-rejection period from April 2005 through July
 28 2005 pursuant to § 365(d)(10) ("Pre-Rejection Payments"). The court agrees with Celtic

1 on the first point. Celtic is entitled to receive the Pre-Rejection Payments at the amount
 2 stated in the Lease. The plain language of § 365(d)(10) required the Debtor to timely pay
 3 the rent due until the Lease “from or after 60 days after the order for relief” until the
 4 Lease was rejected. The Debtor stopped making the Lease payments after expiration of
 5 60 days and Celtic is not claiming any payments during that period. Construing virtually
 6 identical language in § 365(d)(3), the Ninth Circuit stated in *In re Pacific-Atlantic*
 7 *Trading Co.*, 27 F.3d at 404:

8 By providing for timely performance of *all* lease obligations, “notwithstanding
 9 section 503(b)(1),” the statute has already granted priority payment status to the
 10 full amount of rent due The fact that a trustee does not comply with this
 11 directive before the lease is rejected cannot justify denying a lessor the priority
 treatment for the full amount which Congress has already bestowed upon it.
 (emphasis original.)

12 Second, Celtic argues that the 2005 Extension created an independent
 13 administrative liability for the full term of the extension and that Celtic is therefore
 14 entitled to receive post-rejection lease payments for the remainder of the 2005 Extension;
 15 for the period from August 2005 through to April 2006 (“Post-Rejection Claim”). Here,
 16 the court disagrees in part with Celtic. The “extended” Lease was never formally
 17 assumed pursuant to § 365(a), so the full “extended” term of the Lease did not become an
 18 administrative liability. The 2005 Extension extended the term of the Lease, but it did
 19 not cut off the Debtor’s right to reject the Lease during that term. Celtic is entitled to an
 20 administrative claim under § 503(b) measured by the “actual and necessary” value to the
 21 estate of the Debtor’s hold-over possession and use of the Equipment. This amount is
 22 presumed to be the amount stated on the face of the Lease, but this presumption is
 23 rebuttable upon a showing that the actual use value of the Equipment was demonstrably
 24 less. *In re Trak Auto Corp.*, 277 B.R. 655, 667 (Bankr. E.D. Va. 2002)). Accordingly,
 25 the value of the Post-Rejection Claim is a question of fact and will require discovery and
 26 additional evidence.

27 Third, Celtic argues that it is entitled to recover the value of the Equipment on the
 28 theory that the Equipment was converted post-rejection (“Conversion Claim”). The court

1 does not have enough evidence to determine whether a conversion of the Equipment has
2 actually occurred, when it occurred, or what the damages should be. The Conversion
3 Claim, if any, may or may not be entitled to administrative priority depending, *inter alia*,
4 on if and when the alleged conversion actually occurred. *See In re National Refractories*
5 & Minerals Corp., 297 B.R. 614, 619 (Bankr. N.D. Cal. 2003) (landlord's administrative
6 claim for real property damage depends on when the damage occurred). Again, that issue
7 will require discovery and an evidentiary hearing.

8 **Conclusion**

9 Based on the foregoing, the Court finds and concludes that the Master Lease
10 Agreement and related documents constitute a true lease. Accordingly, the Motion by
11 Celtic Leasing for Payment of Administrative Claim will be granted to the extent Celtic
12 seeks allowance and payment of the Pre-Rejection Payments. Celtic's Post-Rejection
13 Claim is entitled to administrative priority under § 503(b) in an amount to be determined
14 in a future evidentiary hearing. Likewise, Celtic's alleged Conversion Claim will require
15 an evidentiary hearing. The Debtor's Objection to Administrative Expense Proof of
16 Claim No. 335 will be denied to the extent the Debtor wants all of Celtic's Claim
17 disallowed, or classified as an unsecured non-priority claim. By separate order, this
18 matter will be set for further briefing and hearing with regard to liquidation of Celtic's
19 Post-Rejection Claim and allowance of the Conversion Claim.

20 DATED: May 17, 2006

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W. Richard Lee
United States Bankruptcy Judge

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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA

CERTIFICATE OF MAILING

The undersigned deputy clerk in the office of the United States Bankruptcy Court for the Eastern District of California hereby certifies that a copy of the document to which this certificate is attached was mailed today to the following entities listed at the address shown on the attached list or shown below.

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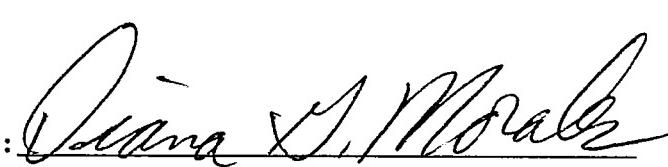
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DATED: May 18, 2006

By: 
Deputy Clerk